BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

"In the Matter of the Appeals of)
)
WALTER M. KEENE AND ELLEN R. KEENE)
and WALTER M. KEENE, FIDUCIARY OF)
THE ESTATE OF ARTHUR M. KEENE)

Appearances:

For Appellants: Archibald M. Mull, Jr., Attorney at Law

For Respondent: F. Edward Caine, Senior Counsel

O P I N I O N

These appeals are made pursuant to section 18594 of the Revenue and Taxation Code from the action of the Franchise Tax Board on protests to proposed assessments of additional personal income tax as follows:

Appellant	Year	Amount
Walter M. Keene and Ellen R. Keene	1951	$3,991.01
	1952	4,755.70
	1953	7,737.60
	1954	9,671.88
	1955	7,632.66
Walter M. Keene; Fiduciary of the Estate of Arthur M. Keene	1951	1,058.92
	1952	1,243.01

The Kenomatic Amusement Company operated a coin machine business in the Taft area during the years 1951 through September 1955. During the years 1951 and 1952 Kenomatic Amusement Company, hereinafter referred to as Kenomatic, was the business name wed by a partnership comprised of appellant

Walter M. Keene and the Estate of Arthur M. Keene and it was also used by appellant Walter M. Keene for his individual coin machine route. During the years 1953 through September 1955, Kenomatic was operated by appellant Walter M. Keene as a sole proprietorship. In addition to about 14 multiple odd bingo pinball machines, Kenomatic owned many music machines and cigarette vending machines and some miscellaneous amusement machines, with the total number of coin machines numbering well over one hundred. The equipment was placed in about 75 locations, such as bars and restaurants. The proceeds from each machine except cigarette machines and music machines, after exclusion of expenses claimed by the location owner in connection with the operation of the machine, were divided equally between the machine owner and the location owner. No detailed information was introduced with respect to the operation of the cigarette machines and apparently the gross income therefrom is not in issue. After exclusion of expenses, Kenomatic retained, various percentages of the proceeds from the music machines.

The gross- income reported in tax returns was the total of amounts retained by Kenomatic from locations. Deductions were taken for depreciation, cost of phonograph records and other business. expenses. Respondent determined that Kenomatic was renting space where its bingo pinball machines and miscellaneous amusement machines, excepting music machines, were placed and that all the coins deposited in those machines, constituted gross income to Kenomatic. As to music machines, the Franchise Tax Board did not add back the location owner's share to that retained by Kenomatic. Respondent also disallowed all expenses, except the cost of cigarettes, popcorn and candy, pursuant to section 17297 (17359 prior to June 6, 1955) of the Revenue and Taxation Code which reads:

> In computing taxable income, no deductions shall be allowed to any taxpayer on any of his gross income derived from illegal activities as defined in Chapters 9, 10 or 10.5 of Title 9 of Part 1 of the Penal Code of California; nor shall any deductions be allowed to any taxpayer on any of his gross income derived from any other activities which tend to promote or to futher, or are connected or associated with, such illegal activities.

Appeals of Walter M. Keene and Ellen R. Keene and Walter M. Keene, Fiduciary of The Estate of Arthur M. Keene

The evidence indicates that the operating arrangements between Kenomatic and each location owner were the same as those considered by us in Appeal of C. B. Hall, Sr., Cal. St. Bd. of Equal., Dec. 29, 1958, 2 CCH Cal. Tax Cas. Par. 201-197, P-H State & Local Tax Serv. Cal. Par. 58145. Cur conclusion in Hall that the machine owner and each location owner were engaged in a joint venture in the operation of all machines except cigarette machines is, accordingly, applicable here.

In Appeal of Advance Automatic Sales Co., Cal. St. Bd. of Equal., Oct. 9, 1962, CCH Cal. Tax Rep. Par. 201-984, P-H State & Local Tax Serv. Cal. Par. 13288, we held the ownership or possession of a pinball machine to be illegal under Penal Code sections 330b, 330.1 and 330.5 if the machine was predominantly a game of chance or if cash was paid to players for unplayed free games, and we also held bingo pinball machines to be predominantly games of chance.

Three location owners who had bingo pinball machines from Kenomatic appeared as witnesses at the hearing of this matter. Two of them testified that cash was paid to winning players for unplayed free games. The third location owner; while claiming to have only a faint recollection in regard to payouts, identified several collection reports which indicated the reimbursement of expenses averaging 46.6 percent of the total amount deposited in the machines, A person employed by Kenomatic during the years 1944 to 1956 as a collector, mechanic and manager, testified that he was instructed to accept whatever was claimed as reimbursement for expenses and ventured a guess that **the expenses averaged 50 percent of the amounts in the machines.**

From the evidence before us we conclude that it was the general practice to make cash payouts to players of bingo pinball machines for free games not played off. Accordingly, this phase of Kenomatic's business was illegal, both on the ground of ownership and possession of bingo pinball machines which were predominantly games of chance **and on the ground that. cash was paid to winning players. Respondent was therefore correct** in **applying section 17297.**

There were no **records** of amounts paid to **winning players on bingo pinball machines, and in order to reconstruct the gross income therefrom respondent estimated these unrecorded**

amounts as equal to 37.5 percent of the total amounts deposited in the machines. Respondent 's auditor testified that the 37.5 percent payout figure represented the average of the actual expenses shown on about 143 collection reports. The 37.5 percent payout figure appears reasonable and in the absence of other information it must be sustained.

In connection with the computation of the unrecorded payouts, respondent's auditor treated -that portion of Kenomatic's income which, was recorded as "Game Income" as arising entirely from bingo pinball machines. The evidence indicates, however, that some of the. "Game Income" arose from miscellaneous amusement machines. In the absence of exact information in this regard, we conclude that 90 percent of the. "Game Income" was attributable to bingo pinball machines.

Except for the cost of goods sold, respondent disallowed all of the business expenses attributable to Kenomatic's coin machine business for each of the years under appeal. The illegal activity, however, was not significant in relation to the rest of the business. The evidence indicates that during 1951 through September 1955, Kenomatic had coin machines at about 75 locations on the average, with bingo pinball machines placed at only eight or nine of these locations. The predominance of other machines over bingo pinball machines is further reflected by evidence indicating that Kenomatic had only 14 bingo pinball machines while the total number of coin machines was well in excess of one hundred. We are of the opinion that under a reasonable interpretation of section 17297 the overall operation of the coin machines did not tend to promote or further, and was not connected or associated with, the illegal activities.

We believe., however, that the operation of coin machines in the same locations with bingo pinball machines did tend to promote or further and was connected or associated with the illegal activity of operating bingo pinball machines. Accordingly, the expenses to be disallowed are all the expenses of the bingo pinball machines and all expenses of coin machines in the same locations with bingo pinball machines. In the absence of evidence of the exact amount of expenses, we believe that 20 percent of the total expenses of the coin machine business during each of the years.' in question would reasonably reflect the expenses of the bingo pinball machines and the expenses of

coin machines placed in the same locations with the bingo machines.

At the hearing of this matter, some question was raised by appellants' counsel with respect to whether a deduction for "Entertainment and miscellaneous expense in securing and maintaining business," which was claimed in the amount of $1,800 for each of 'the years 1951, 1952, 1953, 1954 and 1955 by appellants Walter M. Keene and Ellen R. Keene, was properly disallowed as being attributable to the coin machine business. Appellants have notestablished that this deduction was not attributable to the coin machine business. We conclude, however, that only 20 percent of the $1,800 claimed in each of the aforesaid years by appellants Walter M. Keene and Ellen R. Keene should be disallowed as being attributable to the bingo pinball machines and the coin machines placed in the same locations with the bingo machines.

O R D E R

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

. IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 18595 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on protests to proposed assessments of additional personal income tax as follows:

Appellant	Year	Amount
Walter M. Keene and Ellen R. Keene	1951	$3,991.01
	1952	4,755.70
	1953	7,737.60
	1954	9,671.88
	1955	7,632.66
Walter M. Keene, Fiduciary of the Estate of Arthur M. Keene	1951	1,058.92
	1952	1,243.01

be modified in that the gross income and expenses are to be recomputed in accordance with the opinion of the board. In all other respects the action of the Franchise Tax Board is sustained.

Done at San Francisco, California, this 17th day of March, 1964, by the State Board of Equalization.

Paul R. Leake, Chairman

John W. Lynch, Member

Geo. R. Reilly, Member

Richard Nevins, Member

_____, Member

ATTEST: _____, Secretary